The *Altera* Case: Tax Ramifications of Stock-Based Compensation

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Stock-based compensation (SBC) serves as a popular tool to complement cash-based compensation by incentivizing entrepreneurs, executives, employees and independent contractors by aligning their interests towards corporate performance and goals. On the downside, corporations have to navigate the complex FASB guidance of Accounting Standards Codification (ASC) 718 (formerly SFAS No. 123(R)) to recognize, measure and disclose SBC in corporate financial reports – including implications on earnings per share and cash flow statements. Additionally, these rules have implications in income tax compliance, accounting for income taxes and transfer pricing. This was the subject of discussion in the Accounting for Incomes Taxes session at the 31st Annual TEI-SJSU High Technology Tax Institute. The esteemed speakers Tom Dong, Partner with Deloitte Tax LLP, Louis Gomes, Partner with BDO US, LLP and Dean Kamahele, Principal with KPMG LLP, underscored the tax complexities of SBC that resulted from FASB guidance and the IRS rules and regulations. This article mainly covers the recent developments of SBC of in the context of transfer pricing and its potential implication to corporate taxpayers.

Altera Vs. IRS: Highlights

The focus of the session was the *Altera* case involving cost sharing of SBC between related parties, where *Altera* prevailed against the IRS.[79] The Tax Court's unanimous decision (15-0) invalidated the Service's cost sharing regulations issued in 2003 that required corporations engaged in cost sharing agreements (CSA) with foreign affiliates to share SBC expenses among the parties.[80] In building its argument, Altera relied on a number of items of evidence, including those presented in the 2003 regulation's rule-making process. The focus of Altera's arguments was that unrelated parties would not share the costs of SBC with each other (i.e., essentially, the arm's-length standard). This arm's-length standard was not included in the creation of the 2003 regulations.

The arm's-length standard is the foundation of Internal Revenue Code §482 and its underlying regulations, as well as in tax treaties. The IRS failed to take into account this third party comparable data in the enactment of the 2003 regulations and the Service argued that this standard should, theoretically, not be a determining factor for the inclusion of SBC in CSAs. In this regard, the Court dismissed the Service's argument by pointing out that the preamble to the final rule did not justify the final rule to deviate from the arm's length standard. Further, the Court determined that the 2003 regulation was a legislative rule because it has the force of law and thus it was subject to the "reasonable decision making" standard under §553 of the Administrative Procedures Act (APA).[81] The Tax Court held that the IRS violated the APA since the 2003 regulation was based on economic theories rather than on a factual basis and "was contrary to evidence presented to Treasury during the rulemaking process." By disconnecting themselves from the facts found and ignoring significant comments

[79] Altera Corp. v. Commissioner, 145 T.C. 3 (2015)
[80] Treasury Regulation § 1.482-7(d)(2)
[81] §706(2)(A) APA

during the rulemaking process of the 2003 regulations, the Tax Court concluded that the IRS failed to satisfy the reasoned decision making standard under U.S.C. §706(2)(A) and Motor Vehicle Manufacturers' Association of the U.S. v. State Farm Mutual Auto Insurance Co., 463 U.S. 29 (1983).

Nevertheless, the decision to invalidate the 2003 regulation is not final until 90 days after the decision is entered. The IRS can acquiesce the Court decision or appeal the decision entered by the Tax Court during the 90-day period. If the IRS choses to appeal, the decision is not final until the appellate court renders its final decision. The panel said, "The decision may take years to be resolved on appeal." As of the presentation the IRS extended the 90-day period and was negotiating for final settlement with *Altera*.

Implications of the Case

Pre-*Altera,* most U.S. taxpayers with CSAs shared SBC costs to comply with the existing regulations and had Clawback clauses in their CSA contracts. Clawback clauses usually provide that the U.S. party to the CSA will repay prior SBC cost-sharing reimbursements if and when there is any relevant change in laws (i.e. IRS withdrawing the 2003 regulations or the U.S. Supreme Court invalidating the 2003 regulation). As of the date of the presentation the *Altera* decision was appealable and was not yet a final decision. All things considered, taxpayers must evaluate and take steps in considering the *Altera* opinion in the tax return and financial statement reporting purposes. There are three possible approaches that a taxpayer can undertake:

1. The U.S. participant to a CSA should consider the entire clawback payment in the current year tax return and not file the amended tax returns;
2. The U.S. participant to a CSA should file the amended tax return for the open years they received the recharge payment from their foreign affiliates; or
3. If there is a provision in the CSA, the U.S. participant to CSA can treat the overpaid portion of prior cost-sharing payments as advance credits for the current or future cost-sharing payments.

The first approach might cause taxpayers to incur an accuracy-related penalty for taking a tax position contrary to a regulation.[82] To avoid these penalties, the taxpayer should challenge the validity of the regulation in good faith, that the contrary position has a realistic possibility of being sustained on its merits and the position is disclosed on a Form 8275-R, Regulation Disclosure Statement (attached to federal tax return). The EPS and operating cash flows for the current year could produce abnormal results under this approach.

The second approach might not be possible since Treasury Regulation § 1.482-1(a)(3) prohibits any taxpayer-initiated transfer pricing adjustment for prior years that results in reduced U.S. taxable income. If this adjustment does not involve an "after-the-fact tax planning or fiscal evasion or is otherwise inconsistent with sound tax administration," then corporations might be able to circumvent the prohibition and self-initiate an adjustment on the basis of an invalidated regulation. [83] Taxpayers should consider the statute of limitations and any closing agreements in place with IRS in evaluating amendments of any open year tax returns. The approval of the Joint Committee on Taxation might be essential for amending past returns.

[82] Treasury Regulation §1.6662-3(b)(2) and §1.6662-3(c)(2)
[83] Notice 2013-78

Tom Dong illustrated the implication of the ruling on provisions for income tax with the following example: U.S Parent (USP) historically received $100 of income per year from charging out to its Controlled Foreign Corporation (CFC). Taking the *Altera* position, the USP should have $100 less income, which could create a $100 current year loss that can be carried forward to offset future taxable income. A deferred tax asset (DTA) account of $40 (assuming a 40% statutory tax rate) and a full valuation allowance of $40 would be created to offset the DTA. The DTA would vary depending on the method applied by the corporation and it should choose and consistently apply that one method. Uncertain tax positions should be recognized and measured based on FIN48 rules. The USP would have more foreign-sourced income and consequently the USP might be able to fully utilize its creditable foreign taxes paid from increased foreign tax credit limit.[84] Correspondingly, APB23 on Indefinite Reinvestment of Earnings is triggered upon the increase of offshore cash.

Absent a reversal on appeal, the *Altera* opinion has broader implications for matters involving the validity of the regulations issued by Treasury Department. Taxpayers may be more tempted to challenge regulations if they believe they do not reflect reasoned decision-making supported by empirical evidence. For instance, taxpayers could rely on the *Altera* decision to invalidate Treasury Regulation § 1.482-9(j) that requires a service provider to charge a portion of its SBC to a service recipient in intercompany transactions. Similarly, repercussions of the *Altera* case could have its reach in other areas of tax, such as in base erosion and profit shifting (BEPS) initiatives by the Organization for Economic Cooperation and Development (OECD) where certain proposed rules were criticized by corporations for lacking empirical evidence.

To conclude, *Altera* has provided a landmark victory for taxpayers. Taxpayers should take decisions cognizant of future developments in the SBC area.

[84] §904 (a)

$$\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} \times \text{Tentative U.S. Tax Liability} = \text{FTC Lin}$$